



## **DECLARATION OF GREGORY L. ROSSTON**

on Behalf of AT&T Corp. in the Matter of  
Low-Volume Long-Distance Users,  
CC Docket No. 99-249

### **I. INTRODUCTION**

1. My name is Gregory L. Rosston, and I am a Research Fellow at Stanford University's Stanford Institute for Economic Policy Research and a Lecturer in the Economics Department at Stanford University. I received my Ph.D. and M.A. in economics from Stanford University, and my A.B. with Honors in economics from the University of California, Berkeley. I specialize in the economic study of industrial organization and regulation with an emphasis on telecommunications. I authored or co-authored several published articles relating to telecommunications competition policy and spectrum policy, and co-edited two books on telecommunications. I served at the Federal Communications Commission ("Commission") for three and one-half years as a senior economist in the Office of Plans and Policy, as Acting Chief Economist of the Common Carrier Bureau, and as Deputy Chief Economist of the Commission. In these positions, I was significantly involved with the Commission's implementation of the Telecommunications Act of 1996 ("1996 Act") and with many other competition-related issues. My full *curriculum vitae* is attached as Exhibit 1 to this declaration.

2. I was asked by AT&T Corp. ("AT&T") to analyze the issues raised by the Commission in its Notice of Inquiry regarding Low-Volume Long-Distance Users ("NOI").<sup>1</sup> The NOI seeks comments on the impact of certain flat-rated charges and monthly minimum usage requirements ("MURs") on long-distance customers who make few, or no, interstate long-distance calls. Specifically, the Commission is seeking comment on the methods used by long-distance carriers to pass through to their subscribers the presubscribed interexchange carrier charge ("PICC") and universal service fund ("USF") charge and the MURs imposed by many carriers, including AT&T. The Commission also requests commenters to address a variety of regulatory measures

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<sup>1</sup> Low-Volume Long-Distance Users, Notice of Inquiry, CC Docket No. 99-249 (rel. July 20, 1999) ("NOI"). The Commission's NOI primarily appears to be concerned with residential long-distance customers and thus the data analysis and discussion herein targets these customers and the residential long-distance market. However, the long-distance business market is also highly competitive. Therefore, those portions of my analysis of the Commission's proposals that are premised on the competitiveness of the residential long-distance market obviating the need and benefit of regulation are equally applicable to the long-distance business market.

that the Commission may consider implementing in what would be a misguided effort to reduce the impact that the Commission perceives that flat-rated charges and MURs have on low-volume long-distance customers.

3. Based on my analysis of the issues raised in the NOI, I have reached the following conclusions:

- Low-volume residential users are very heterogeneous, and have incomes that are similar to the overall long-distance customer base. Moreover, large numbers of high-income individuals are low-volume residential long-distance users.
- For a variety of reasons, flat-rated charges and AT&T's MUR have little impact on long-distance customers, and, due to the AT&T Lifeline Program, no effect on many AT&T low-income, low-volume users.
- Because the long-distance market is highly competitive and competitive markets protect customers, the Commission should refrain from imposing additional regulations on long-distance carriers. To succeed in the competitive long-distance market, carriers must offer pricing plans that match customer preferences and are based on carrier costs. As a result, long-distance customers benefit from a plethora of long-distance pricing and carrier options. Any attempt by the Commission to regulatorily mandate the structure of pricing in the long-distance market will harm consumers by preventing carriers from employing economically efficient cost-based pricing and tailoring their pricing plans to satisfy customer preferences.
- Because the Bell Operating Companies ("BOCs") continue to provide the vast majority of local exchange service in their territories and the majority of the telecommunications expenses incurred by low-volume long-distance users are for local exchange service, the Commission should focus its attention on promoting competition in the local exchange. Permitting BOCs to compete in the long-distance market before the BOCs have satisfied the local exchange market opening requirements imposed by the 1996 Act will not benefit low-volume long-distance users and will significantly delay the increase in local competition that will be caused by the opening of the local exchange markets.

4. These opinions are based on my extensive analysis of AT&T's billing records in conjunction with U.S. Census demographic data. I have also analyzed AT&T's billing practices in order to understand their effect on AT&T's subscribers, and in particular on low-volume callers. In addition, I have examined the nature of the long-

distance market and the pricing plans of other long-distance carriers to better understand the competitive dynamics of the market and the likely effect that additional regulation would have on long-distance customers and providers.

5. My analysis of AT&T's residential customer data show that AT&T's low-volume long-distance customers that are likely to incur AT&T's new MUR are similar in income level to AT&T's total customer base. Both groups include many high-income and low-income subscribers. Thus, regulatory requirements that aim to reduce the cost of long-distance service for low-volume customers by shifting these costs from low-volume to high-volume customers would necessarily cause some low-income customers to pay more so that some high-income households can pay less. In addition, under the AT&T Lifeline Program, low-income customers are not required to pay the MUR, PICC pass-through, or USF charge. Thus, any concern by the Commission that low-income long-distance users will be disproportionately affected by AT&T's MUR is misplaced. Other AT&T subscribers can reduce or eliminate the impact of the MUR in a variety of ways. Further, even if AT&T customers would be substantially affected by the MUR, the highly competitive nature of the long-distance market assures that they have hundreds of other long-distance carriers that have both the ability and incentive to undercut any MUR that does not actually reflect AT&T's cost of serving low-volume customers.

6. AT&T charges residential customers a flat-rated PICC pass-through and USF charge. AT&T charges residential customers a blended flat-rated PICC pass-through because AT&T did not have sufficient information in the past to differentiate between primary and non-primary lines. Although AT&T now receives this information from most incumbent local exchange carriers ("ILECs"), because primary and non-primary PICCs will gradually converge over the next several years into a single residential PICC, AT&T has determined that it would not be efficient to expend the resources necessary to alter its billing systems and educate its millions of residential customers about a new method of assessing the PICC pass-through. AT&T charges a flat-rated USF charge to conform with its residential customers' preferences as demonstrated by a customer survey undertaken by an independent third party, and to reduce the administrative costs of passing through the USF charge to customers. If subscribers are unhappy with AT&T's method of recovering these charges, other long-distance firms have adopted different strategies to pass through these costs to their subscribers.

7. Given the highly competitive and rapidly changing nature of the telecommunications marketplace and strong empirical evidence that competition does a better job of protecting consumers than governmental regulation no matter how well intentioned, it is clear that the Commission should not consider re-regulating the long-distance industry. The NOI sends an alarming message to entities that are regulated or potentially regulated by the Commission. The NOI suggests that competitive firms that incur fixed costs to serve their customers, some of which are directly imposed by regulators, may be threatened with regulation if the firms recover these costs in a manner that the firms believe to be appropriate and economically reasonable in light of their

customer's preferences. The Commission should promptly end this inquiry and make clear that it does not intend to embark on such a course.

## **II. BACKGROUND**

8. The telecommunications industry has evolved significantly over the past 15 years. Most recently, deregulation of the interexchange market<sup>2</sup> and the implementation of the pro-competitive directives of the 1996 Act have caused a substantial reduction in long-distance rates.

### **A. Deregulation and Competition**

9. The Commission has taken a markedly deregulatory approach in the long-distance market in the past five years. This approach has resulted in significant benefits for consumers, including reduced long-distance rates and increased customer choice. In a 1996 Notice of Proposed Rulemaking, the Commission readily acknowledged that:

[t]he interstate, domestic, interexchange market has evolved from a market of fledgling competitors overshadowed by a single, dominant service provider to a market characterized by substantial competition. The Commission explicitly acknowledged these dramatic changes when, in October 1995, we concluded that AT&T . . . no longer possessed individual market power in the domestic long-distance market taken as a whole and, accordingly, reclassified AT&T as a non-dominant carrier for interstate, domestic, interexchange services.<sup>3</sup>

10. Even then, it was not likely that the Commission imagined that long-distance service would be universally available 24 hours a day a few years later for seven

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<sup>2</sup> The term "interexchange" refers to long distance, or interLATA, traffic. A LATA, or Local Access and Transport Area, is a geographic boundary established for regulatory purposes after the divestiture of AT&T that determines the limits of the area in which a BOC is permitted to provide service. Under the 1996 Act, the BOCs are forbidden from providing (with certain limited exceptions not relevant here) interLATA wireline telecommunications services originating in the states within their service territories until they meet the requirements of Section 271 of the Act.

<sup>3</sup> In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace Implementation of Section 254(g) of the Communications Act of 1934, as amended, Notice of Proposed Rulemaking, 11 FCC Rcd 7141 (1996).

cents a minute as a result of the intense competition in the deregulated long-distance industry.

11. With the introduction of new technologies, such as IP telephony and advanced wireless services, end users' options for interexchange service will increase even further. In addition, programs narrowly tailored to the preferences of subsets of consumers will continue to proliferate. This is exactly the kind of competition contemplated by the 1996 Act.

12. In the 1996 Act, Congress adopted a "procompetitive and deregulatory" philosophy toward telecommunications. In nearly every order implementing the Act, the Commission has alluded to this philosophy and attempted to encourage the development of a competitive marketplace, particularly for local telephone service. The reason the Commission has correctly focussed on local telephone service, rather than long-distance service, is because there are few barriers to entry into long-distance service. A large number of long-distance carriers provide wholesale and retail long-distance service, and there continues to be extensive new entry into the long-distance market. The number of long-distance carriers in the U.S. increased from 210 in 1986 to 621 in 1996.<sup>4</sup> In addition, the rise of new facilities-based companies like Qwest, Level 3, and Frontier will further increase the competitiveness of the industry. The Commission's deregulation of the long-distance industry demonstrates the Commission's recognition that pervasive long-distance competition is the best way to ensure that consumers receive the best possible prices and services.

**B. Explicit Subsidies**

13. The 1996 Act required the Commission to make explicit, and to remove to the extent possible, subsidies that were previously implicit in order to facilitate additional competition in the local and long-distance markets. The telecommunications industry historically has been rife with implicit subsidies. Congress correctly realized that in a market characterized by increased competition, new carriers will use implicit subsidies that are directly or indirectly attributable to regulation in order to gain a competitive advantage over carriers that are burdened by the regulatory subsidies. Specifically, new competitors will gain market share from carriers funding implicit subsidies by undercutting the prices that existing carriers charge to certain types of customers to fund the implicit subsidies. New competitors are able to do so because, to the extent they can avoid the implicit subsidies, they are not required to charge supracompetitive rates to fund the subsidy.

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<sup>4</sup> Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, July 1998.

14. For example, long-distance companies realized that they, like local telephone companies, incur a fixed cost to serve each customer. Sprint, MCI, and many other companies took advantage of the flexibility provided to them by the Commission's deregulation of the long-distance industry to charge their customers MURs to cover these fixed costs. By contrast, AT&T refrained from assessing an MUR because AT&T was subject to more stringent regulatory oversight and therefore presumably feared that assessing an MUR would provoke additional burdensome regulation of the type contemplated by some portions of the NOI. However, based on economic theory, it was predictable that AT&T could also adopt procompetitive pricing practices once released from the shadow of regulation. By not initially assessing an MUR, AT&T created an implicit subsidy to low-volume customers that adversely affected AT&T's ability to compete with new entrants. This subsidy was exactly the kind of implicit subsidy that Congress realized was unsustainable in competitive markets. Thus, any attempt to prevent long-distance providers from setting rates so as to decrease or eliminate such implicit subsidies would be fundamentally inconsistent with the procompetitive intent of the 1996 Act.

C. Flat-Rated Charges

15. As a result of the increasing competitiveness of and changing regulation in the long-distance industry, long-distance carriers charge their customers several different flat-rated charges to recover federally mandated charges and the fixed costs of serving customers.

1. *Presubscribed Interexchange Carrier Charge ("PICC")*

16. The Commission has in recent years increasingly sought to structure charges that recover costs of the local loop attributable to the origination and termination of interstate calls in a manner that is more consistent with the non-traffic sensitive nature of the costs of the loop. These charges replaced a system in which the non-traffic sensitive costs of the local loop were recovered through per-minute charges, which resulted in a subsidy flowing from high-volume long-distance users to low-volume users. To offset the Commission-mandated reduction in the inflated per-minute charges, the Commission instituted the PICC.<sup>5</sup> The PICC is assessed by local exchange providers to interexchange carriers ("IXCs") to which their customers presubscribe and ranges from \$1.04 for primary lines to \$2.53 for non-primary residential lines. Interexchange

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<sup>5</sup> The Commission also implemented a subscriber line charge ("SLC"), which local exchange providers recover directly from their end-user customers. The SLC currently is \$3.50 per month for primary residence lines (and higher for secondary and business lines).

providers typically recover the PICC and the administrative costs of collecting the PICC from their customers as an averaged, flat-rated charge. For instance, AT&T charges its residential customers a PICC pass-through of \$1.51 per account.

2. Universal Service Fund ("USF") charge

17. The Commission collects money to support its Schools, Libraries and Rural Health Care Fund, and Rural High Cost and Low-Income Fund, which subsidize telecommunications services provided to certain individuals and entities. These programs are expected to cost slightly more than \$1.1 billion in the 4<sup>th</sup> quarter of 1999.<sup>6</sup> The Commission requires all telecommunications providers, including long-distance carriers, to fund these universal service programs by contributing a percentage of their gross interstate and intrastate telecommunications revenues. This percentage is determined based on the ratio of the total telecommunications revenues collected by all telecommunications providers during the prior period (usually a delay of 6 months) to the expenditures of the programs in that year. The most recent USF surcharges assessed by the Commission are 3.99% and 1.1% on interstate and intrastate revenues, respectively.<sup>7</sup> Like Qwest and Excel, AT&T charges its residential customers an averaged flat fee to recover its USF contribution requirement and the administrative costs AT&T incurs collecting the USF charge. Specifically, AT&T charges its residential customers \$0.99 per account.

D. Minimum Usage Requirement ("MUR")

18. Before AT&T was declared non-dominant by the Commission, AT&T did not charge an MUR to its basic rate customers.<sup>8</sup> However, with the increase in competition for high-volume customers and AT&T's relief from direct regulation, AT&T found that it made competitive sense to institute an MUR for all of its customers to cover the per-customer cost of maintaining each account, such as billing, customer service, customer acquisition, and network availability. Thus, AT&T began to charge an MUR in January 1999 to Basic Schedule customers that had presubscribed to AT&T for InterLATA service after August 14, 1999, and imposed this fee on all existing basic rate customers effective June 1999.

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<sup>6</sup> Proposed Fourth Quarter 1999 Universal Service Contribution Factors, Public Notice, CC Docket No. 96-45, DA 99-1857 (rel. Sept. 10, 1999).

<sup>7</sup> Id.

<sup>8</sup> However, like most other IXC carriers, AT&T did charge monthly fees to customers that enrolled in certain reduced-price calling plans.



19. AT&T's flat monthly MUR is \$3.00 per month for its basic rate customers and for customers who enrolled after August 14, 1998 in the AT&T One Rate<sup>®</sup> Plan, which does not impose a monthly fee.<sup>9</sup> Thus, if a customer subject to the MUR incurs \$2.00 of long-distance toll charges in a month, the customer will be charged an additional \$1.00. In essence, the MUR is like a flat-rated charge with a certain number of included minutes because usage up to \$3.00 each month is effectively free. Other long-distance carriers also offer calling programs with monthly MURs. For example, customers enrolling in Sprint's Sprint Sense program are subject to a MUR of \$5.00, and MCI's basic rate schedule includes a MUR of \$3.00.<sup>10</sup>

**III. INCOMES OF LOW-VOLUME LONG-DISTANCE USERS AND HIGH-VOLUME LONG-DISTANCE USERS ARE SIMILAR**

20. The NOI seeks comment on whether the effects of MURs on "any subset of consumers" are "sufficiently significant, unanticipated, inequitable, and/or uneconomic to warrant regulatory intervention."<sup>11</sup> My analysis of customer billing data provided to me by AT&T demonstrates that there is no homogeneous group of customers who are low-volume long-distance users. Thus, the effect, if any, of MURs on low-income customers is not disproportionate and no Commission action is warranted to prevent MURs from disproportionately impacting low-income customers.

21. I examined sample data from AT&T on calling patterns of nearly 3 million randomly selected AT&T residential long-distance customers that were presubscribed to AT&T for interLATA service on August 8, 1999.<sup>12</sup> The AT&T data include information

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<sup>9</sup> AT&T does not impose a MUR in areas where equal access has not been implemented because customers in these areas do not benefit from the competitive long-distance alternatives available to the rest of the nation's callers. However, these customers do benefit from the same competitive rate plans that AT&T offers all other customers.

<sup>10</sup> Sprint, like some other carriers, also offers rate plans that do not include an MUR or monthly fee but that include higher toll rates.

<sup>11</sup> NOI, ¶ 15.

<sup>12</sup> The initial data universe was 57,482,604 Billed Telephone Numbers ("BTNs") that had AT&T as their Primary Interexchange Carrier on August 8, 1999. To make it possible to match usage and Census data, this universe was then restricted to BTNs that received a bill in June 1999 and had geographic coding information. From 34,161,891 BTNs meeting these criteria, a random sample of 2,999,106 BTNs was selected. For this sample of BTNs, AT&T monthly usage data covering the period from July 1998 to June 1999 was obtained.

about each customer's interLATA and intraLATA presubscribed carrier, interLATA charges, intraLATA charges if presubscribed to AT&T for toll intraLATA service, taxes, AT&T Lifeline status, calling plan selection and associated fees, and geographic location. During the time period from which the sample was taken, approximately 57 million customers with active billing telephone numbers ("BTN") were presubscribed to AT&T. My sample of approximately 5.3% of AT&T's presubscribed customer base is clearly sufficient to permit confidence in the statistical accuracy of my results. To supplement AT&T's data, I obtained U.S. Census income data by census tract and assumed that each AT&T customer has the income characteristics of the average household for that census tract. It is impossible to match individual household income data with the AT&T billing data because AT&T does not possess data about the income of its subscribers.<sup>13</sup> However, using the census tract data with a sample of 3 million and consulting other studies that have matched income data with specific bills gives me confidence in the results of my analysis.<sup>14</sup>

22. The NOI solicits comments on "low-volume" customers, but does not provide a definition of the term. I categorized each of the subscribers in the random sample into one of two categories based on their billing records for January 1999. I categorized subscribers who would have been subject to a MUR based on their January 1999 bills as low-volume callers. Thus, subscribers that made less than \$3 worth of toll calls in January 1999, were not enrolled in an optional calling plan with a monthly fee, and were not enrolled in the AT&T Lifeline Program in January 1999 were categorized as

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<sup>13</sup> There are "bill buying" services that obtain billing and income information from individual households, but these bills do not provide some of the details in which I am interested. In particular, they do not separately report intraLATA toll usage, and provide no information about whether a customer is subscribed to an optional calling plan. There also are questions about the sampling methods used to generate this data. However, I have compared my results to published reports based on these data and my results are sufficiently similar that I have no reason to believe using accurate data of the form bill buying services provide would alter my conclusions.

<sup>14</sup> There is a potential for error if the variation in income within a census tracts is large and the calling data is strongly correlated with income because I used income data for census tracts rather than individual households. However, the results obtained here are similar to the results obtained in the PNR Bill Harvesting Survey, which summarizes local and long distance bills and household incomes. Both this study and my analysis show a slight increase in calling volume as income increases. (Crandall, R. W. "Telephone Subsidies, Income Redistribution, and Consumer Welfare," in Noll, R. and Price, M. (ed.s) A Communications Cornucopia, Brookings: Washington. 1998.).

low-volume callers.<sup>15</sup> I defined toll calls to include interLATA, international, and intraLATA toll calls carried by AT&T. If a subscriber did not presubscribe to AT&T for intraLATA toll calling or placed calls using a “dial-around” carrier or via other means, then such usage was not considered in evaluating whether the customer was a low-volume user because these calls would not have counted towards the customer’s MUR and AT&T does not have records of its customers’ calls on other carriers’ networks. Because each billing record is for a unique BTN rather than a unique subscriber, the multiple billing records of subscribers with multiple lines may have fallen into different categories.

A. Low-Volume Usage

23. The average toll usage in January 1999 of low-volume (as defined above) customers was \$0.43. As a result, the average effect of the MUR on AT&T subscribers in this category would have been \$2.57 had the MUR been applicable to these customers in January 1999.

24. However, the above analysis clearly overstates the impact of AT&T’s MUR on low-volume long-distance users for several reasons. First, had the MUR been applicable to all low-volume customers in January 1999, many of the subscribers considered low-volume would have changed their calling behavior or billing practice to avoid the MUR and, by doing so, would no longer qualify as low-volume customers for purposes of my analysis. Very few people in the sample actually were subject to MURs during the sample data period because only customers that presubscribed to AT&T’s long-distance service after August 14, 1998 were subject to the MUR in January 1999. Eighty-one percent of AT&T’s long-distance customers presubscribed earlier than August 15, 1998<sup>16</sup> and thus were not yet subject to the MUR in January 1999. As further

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<sup>15</sup> AT&T exempts from the MUR AT&T One Rate® Plan customers who enrolled in that calling plan on or before August 14, 1998 (when AT&T announced its MUR), and who remained on the AT&T One Rate® Plan. Apparently, AT&T advertising to these pre-existing customers affected its willingness to apply the MUR to these customers. In my analysis, all AT&T One Rate® Plan customers are considered not to be subject to an MUR. The exclusion affects only those customers who signed up for the AT&T One Rate® Plan on or before August 14, 1998 and had less than \$3.00 worth of usage in January 1999. This represents only 0.28% of customers presubscribed to AT&T for interLATA service in January, 1999.

<sup>16</sup> 80.81% of the customers in our sample were presubscribed to AT&T for interLATA service for the entire period of the data (July 1998 to June 1999), and thus would not have been subject to the fee until June 1999.

discussed in the next section, AT&T provides its customers with a wide variety of means to reduce or eliminate the effect of the MUR on their long-distance bill, which methods would also cause the customers to no longer qualify as low-volume callers. Many of the customers that qualified as low-volume customers in January 1999 would have modified their billing behavior or calling to avoid the MUR if they had been subject to the MUR prior to January 1999. The January 1999 data do not account for the shift in behavior of customers that probably would have occurred had the MUR been applied to them prior to January 1999 and thus overstates the percentage of AT&T's presubscribed customers that actually will be subject to the MUR.

25. For example, many of AT&T's customers that did not make any long-distance calls in January 1999 using AT&T could have avoided the MUR if they had been subject to the MUR at that time. About two-thirds (67.7%) of the billing records of customers in the sample data that qualified as low-volume subscribers showed zero AT&T interLATA usage in January 1999. Many of these bills could be for non-primary lines used for Internet access, rather than voice telephone services. The Commission estimated there were 15.7 million non-primary residential lines employed in 1996, which means that between 10% and 15% of homes had second lines.<sup>17</sup> Lines primarily used for Internet access do not generate a significant volume of long-distance revenues because households with such lines also typically have a primary line for voice service. These customers could avoid the MUR by any of several means discussed below in Section IV. In addition, some customers may have used dial-around companies or prepaid calling cards for all of their long-distance usage in January 1999. Had these subscribers been subject to the MUR in January 1999, these subscribers would probably have used AT&T for at least some of their long-distance calls because they effectively could have made the first three dollars worth of calls using AT&T without additional charge.

26. If we exclude customers with zero interLATA usage in a given month from the low-volume users category, the average usage of low-volume users jumps to \$1.29 and the average effect of the MUR on these customers drops to \$1.71. But even \$1.71 probably overestimates the typical monthly impact of the MUR on the remaining low-volume customers after the zero-use customers are excluded. Low-volume households move in and out of the low-volume subscriber category from month to month. For example, a customer may make more than \$3.00 worth of calls in some months and less in others. To quantify this effect, I examined customers who were pre-subscribed to

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<sup>17</sup> Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, July 1998. Note that this number may overstate the number of homes with second lines because some homes have three or more lines. However, even in these homes the primary line can be expected to account for the vast majority of the household's long-distance usage.

AT&T for the entire 12-month period from July 1998 through June 1999. Of this group, I focussed on those subscribers who would have incurred some level of MUR at least once during that year based on their billing records. The average number of months in which these customers would have paid some level of MUR was 6.35 months. Thus, these subscribers used more than \$3 of long-distance nearly half of the time. Therefore, the average impact of the MUR on low-volume users would have been about \$11 ( $\$1.71/\text{months} \times 6.35 \text{ months/year}$ ) annually for the average sample customer that would have been subject to the MUR in January 1999. This figure probably still overstates the actual impact that the MUR would have had on sample customers if the sample customers had been subject to the MUR in January 1999 because many sample customers with some long-distance usage, and thus which we did not exclude from the above calculation, would have changed their calling or billing behavior to avoid the MUR. The \$11 annual impact calculated above only takes into account the anticipated changed behavior and billing practices of zero usage customers.

B. Demographic Information

27. Using my sample data, I calculated the differences in median household income between low-volume callers and the universe of AT&T residential customers in January 1999.<sup>18</sup> Because of the large size of the sample, the income estimates are fairly precise.<sup>19</sup>

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<sup>18</sup> I also examined the other income variables available: mean household income and mean and medium family income. These measures yielded results similar to the results reported in the table. These other three measures had higher incomes in each quartile and slightly lower percentage differences in income between low-volume users and all other users. I am reporting the measure with the greatest disparity, which is still quite small.

<sup>19</sup> In statistical terms, this means that the standard errors of the income estimates are small relative to the size of the income, and therefore even small differences in income are "statistically significant" (that is, with 95% or even 99% confidence). However, the actual magnitudes of the differences are not economically significant. For example, with a sample of 3 million records, it could well be that a \$10 difference in income is statistically significant because large sample sizes tend to produce more precise statistical measurements.

<b>Median Household Income</b>	<b>All Long-Distance Users</b>	<b>Long-Distance Users Who Would Have Paid the MUR in 1/99 (Low-Volume Users)</b>	<b>Percentage Difference</b>
Mean:	\$44,738	\$43,160	3.5%
25 <sup>th</sup> percentile	\$31,176	\$30,263	2.9%
Median:	\$41,160	\$39,964	2.9%
75 <sup>th</sup> percentile	\$54,070	\$52,087	3.7%
Max:	\$500,001	\$500,001	0.0%

28. Several important points are illustrated in the table above. First, the differences in income between the overall group of customers and those subject to the MUR are relatively small—between 2.9% and 3.7% at all levels. The mean for the low-volume customers is \$43,160, whereas the mean for the overall customer base is \$44,738. Even at the low end, the income differences are small. For the 25<sup>th</sup> percentile, the difference is less than \$1,000. The data show that the income distribution of low-volume callers is similar to, but slightly lower than, the income distribution of all callers.<sup>20</sup> Both groups have similar incomes at the 25<sup>th</sup> percentile, median (50<sup>th</sup> percentile) and 75<sup>th</sup> percentile. Not only is the absolute difference less at the low end of the income spectrum, but the percentage difference is also less. This means that at the low end of the income scale, where the Commission may be most interested in the results, the distributions are even more similar than they are overall.

29. In addition, both groups have households in census tracts at the high end of the income spectrum. Low-volume users include a large number of high-income households, and the overall group of AT&T customers includes a substantial number of low-income households that are not low-volume users. Thus, any action undertaken by the Commission to reduce the financial burden on low-volume users will benefit many average to high-income subscribers that can easily afford to pay the MUR to remain presubscribed to a long-distance provider.

30. Further, any Commission regulatory mandate that lowers long-distance prices for low-volume customers by increasing prices to high-volume customers would result in the disproportionate subsidization of high-income, low-volume customers. Low-income, low-volume subscribers that qualify for the AT&T Lifeline Program, which is

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<sup>20</sup> I also calculated the difference between the median household incomes of low-volume users and long-distance users that would not have been subject to the MUR in January 1999 (rather than all long-distance users as in the table above) and the results still show a difference in median household incomes around 4% for each of the income categories listed in the table.

further described below, do not pay any federal flat-rated charges or the MUR and thus would not receive a benefit. High-income low-volume subscribers, by contrast, would benefit. In addition, all high-volume customers, including low-income, high-volume customers, would be charged more if the Commission enacts a regulatory requirement that causes high-volume subscribers to subsidize low-volume subscribers.

31. Thus, there is no clearly identifiable income group affected by the MUR. On average, low-volume users have very nearly the same income as high-volume users and there are significant numbers of both low-income, high-volume users and high-income, low-volume users. Therefore, the Commission has no basis to institute new regulations limiting the use of MURs by long-distance carriers in order to protect low-income users. Such regulation would in fact benefit high-income subscribers with low long-distance volume at the expense of low-income subscribers who make more than a minimal amount of long-distance calls. Given the competitive nature of the long-distance industry and the availability of options that enable customers to avoid or minimize the impact of MURs, the Commission should permit the long-distance market dictate the most efficient way of billing customers and allocating costs.

#### **IV. MURS WILL HAVE LITTLE IMPACT ON CONSUMERS' BILLS**

32. As I have demonstrated above, AT&T's MUR has a relatively small impact in dollar terms on AT&T's low-volume subscribers. However, even low-volume subscribers impacted by the MUR have a variety of options that enable them to lessen or eliminate the impact of the MUR on their monthly long-distance bills. Further, the AT&T Lifeline Program enables low-income, low-volume AT&T customers to avoid paying the MUR and federal flat-rated charges entirely. Of course, AT&T customers that are not satisfied with any of their options to lessen or eliminate the impact of the MUR can subscribe to one of the many long-distance carriers that offer calling plans without MURs, or can choose not to be presubscribed to any long-distance carrier.

##### **A. AT&T Customers Have Several Options to Reduce or Eliminate the Impact of AT&T's MUR**

33. Prior to imposing the MUR, AT&T expended substantial resources to educate its customers about the upcoming change and the impact that the MUR would have on their long-distance bills. AT&T also advised its customers that options were available to them to minimize or eliminate the impact of the MUR.

34. AT&T permits customers to include virtually all of their charges for AT&T services on a single bill and then counts the aggregate bill towards the \$3 MUR. Thus, any AT&T customer that receives at least \$3.00 per month of wireless, long-

distance, intraLATA toll, or local service from AT&T will not be subject to an MUR if they aggregate their billing.<sup>21</sup> Also, AT&T permits customers to aggregate multiple lines to meet the \$3 minimum and thus avoid the MUR.<sup>22</sup> Thus, the many customers that purchase a second line for Internet access can avoid the MUR on the second line by aggregating the bill for the second line with the primary line that they use for voice service. In addition, no customer that subscribes to AT&T for local exchange service will be subject to the MUR. As AT&T expands the geographic scope of its local service, this will become a viable option for many customers. Each of these aspects of AT&T's MUR are cost-justified because AT&T only incurs the cost of billing a customer once regardless of how many different services AT&T provides to the customer.

35. To provide an example of the number of AT&T customers that could benefit from bill aggregation, I analyzed the bills of customers in the sample data that are presubscribed to AT&T for intraLATA toll service to approximate how many of AT&T's long-distance customers would benefit from aggregating intraLATA and interLATA toll services on the same bill. These customers represent 14.5% of the sample of AT&T customers. Within this group, the average intraLATA toll bill is \$5.89. In other words, the intraLATA bill of an average customer in this group is sufficiently high to satisfy the \$3.00 MUR even if the customer makes no interLATA long-distance calls. In order to examine the impact on low-volume customers of interLATA and intraLATA bill aggregation, I also examined the intraLATA toll bills of AT&T customers with less than \$3.00 in interLATA calls. Even for this subgroup, the average monthly intraLATA toll bill was \$3.83, and more than a quarter had sufficient intraLATA charges in January 1999 to avoid entirely the MUR even if they made no interLATA calls.

36. AT&T also does not charge the MUR to customers enrolled in AT&T One Rate® On-Line. Customers enrolled in this plan review their bill on the Internet and their bill is automatically charged to a credit card or debited to a checking account. These customers can obtain significant customer service information on-line, and do not receive a paper bill. This reduces the fixed cost of the customer to AT&T in several ways: AT&T reduces its provisioning costs, does not incur the costs of generating and mailing a paper

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<sup>21</sup> For some customers who request their wireless and wireline service to be combined on a single bill, AT&T is unable to produce a single bill. In these cases, AT&T waives the MUR upon request.

<sup>22</sup> Although AT&T intends to permit customers to aggregate bills from lines in multiple residences, AT&T has not yet developed fully this billing capability. Until AT&T is able to do so, AT&T will, upon request, exempt the secondary residence of multiple residence customers from the MUR.



bill; does not pay postage; is not required to process checks because the bills are charged to credit cards; and experiences less bad debt expense.

**B. Under the AT&T Lifeline Program Low-Income, Low-Volume Customers Are Not Required to Pay the MUR or Federal Flat-Rated Charges**

37. AT&T's low-income, low-volume customers are not required to pay the MUR or federal flat-rated charges if they enroll in AT&T's Lifeline program. When AT&T began applying its MUR last year, AT&T instituted a Lifeline program similar to the Lifeline programs mandated by state public utility commissions. Customers who self-certify that they are enrolled in or eligible for a state Lifeline program also qualify for the AT&T program, under which AT&T waives the MUR, PICC pass-through, and USF charge. More than five million households are enrolled in state Lifeline programs through their local exchange carriers, and all of these households are eligible for the AT&T Lifeline Program if they are presubscribed to AT&T for interLATA service.<sup>23</sup> To assure that customers are fully aware of this option, AT&T will send information about the AT&T Lifeline Program to all of its Basic Schedule customers two times each year, beginning in November 1999. Customers can self-certify their eligibility for the program by calling a toll-free number and then returning an enrollment card mailed to them by AT&T.

38. The AT&T Lifeline Program eliminates the impact of the MUR and flat-rated charges on low-income, low-volume subscribers. Further, in light of the AT&T Lifeline Program, the analysis provided in the previous section on low-income, low-volume users dramatically overstates the impact of the MUR on these customers. As a result of the recent introduction of the MUR, more low-income customers can be expected to enroll in the AT&T Lifeline Program, which will further attenuate any small differential effect of the MUR and increase the average income of low-volume users subject to the MUR. The Commission therefore should have no concerns about the impact of flat-rated charges on low-income subscribers.

**C. The Competitive Long Distance Market Provides Customers With Alternatives to AT&T's Long-Distance Service**

39. As a result of competition in the long-distance market, carriers have developed pricing plans that satisfy the preferences of disparate types of customers and will continue to assure, independent of regulation, that customers are aware of these plans. If an AT&T customer is unhappy with AT&T's MUR and not eligible to reduce the impact of the MUR through one of the means described above, there are a large

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<sup>23</sup> Federal Communications Commission, June 1999 Monitoring Report, Table 2.5.

number of alternative carriers to which the customer can easily switch that offer calling plans that do not impose MURs, or that offer different pricing options and permutations that might better satisfy that customer. Even without any mandate to educate consumers, long-distance carriers already spend huge sums of money on advertising and direct marketing, both of which educate consumers about their long-distance options. According to Competitive Media Reporting, an independent advertising tracking firm, IXCs spent over \$1.5 billion on advertising in 1998. The decline in AT&T's share of the long-distance market over the past several years demonstrates that customers clearly are aware of competitive alternatives to AT&T's service offerings and millions of households continue to switch long-distance providers every month.

40. Finally, a customer can also "de-PIC" by notifying their local exchange provider that they do not want to presubscribe to an IXC. By doing so, a household can avoid MURs entirely.<sup>24</sup> Households that de-PIC can make long-distance calls by dialing a 10-10-XXX number to access a dial-around carrier, or can use prepaid phone cards or calling cards. Dial-around companies offer a large number of pricing options to conform to the preferences of consumers, including fairly low per minute rates with or without monthly fees, and fixed prices for calls up to certain durations, followed by higher per-minute rates. Dial-around companies advertise heavily on television, send direct mail solicitations, and use other methods to ensure that customers are aware of their offerings.

**V. THE COMMISSION SHOULD NOT ENACT ANY OF THE REGULATORY PROVISIONS PROPOSED IN THE NOI BECAUSE THE LONG-DISTANCE MARKET IS COMPETITIVE AND ECONOMIC THEORY COUNSELS AGAINST REGULATING COMPETITIVE MARKETS**

41. Economists have long understood that regulation should only be employed when there is an insufficient level of competition in a market. A competitive marketplace forces all competitors to cater to customer preferences and offer low, cost-based prices, thereby rendering regulation unnecessary. In fact, regulation of a competitive market confuses pricing signals and thus harms consumers' interests. In 1995, the Commission determined that the long-distance market was sufficiently competitive to deregulate the only long-distance company whose prices were then subject to significant regulatory oversight—AT&T.<sup>25</sup> Since that time, long-distance rates have fallen dramatically. In

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<sup>24</sup> However, the household's local exchange provider will then charge the PICC directly to the end user and thus the end-user will not avoid the PICC pass-through.

<sup>25</sup> The Commission substantially deregulated many AT&T long distance services offered to business users prior to 1995. See Motion of AT&T Corp. To Be Reclassified As a Non-Dominant Carrier, Report and Order, 11 FCC Rcd. 3271, at ¶¶ 8-9 (1995). Although the

1995 the notion that residential customers would soon be able to place interLATA calls for seven cents a minute anytime of the day and any day of the week was farfetched, now it is a reality. Because the long-distance market is competitive, the Commission should perpetuate its deregulation of the long-distance market and refrain from imposing additional regulation absent evidence of market failures. I explain below why regulation is unnecessary and harmful in a competitive market, demonstrate that the long-distance market is competitive, and then examine individually why the regulatory actions under consideration by the Commission would not benefit—and could harm—consumers' interests.

**A. Regulation is Unnecessary and Can be Harmful in Competitive Markets**

42. Regulation of pricing decisions by participants in a competitive market is unnecessary and can be detrimental to consumer welfare.<sup>26</sup> Unnecessary regulation imposes direct and indirect costs. The direct costs caused by regulation include the administrative costs of participating in the regulatory process and the costs attributable to the economic inefficiency caused by regulations that prevent competitors from pricing services in an optimally efficient, market-dictated manner.<sup>27</sup> If firms are prevented from charging economically efficient, optimal prices to consumers, consumer welfare will decrease. In addition, the regulatory process exposes pricing plans to competitive review;

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chief focus of this declaration, like that of the NOI, is on residential users, there is also strong competition for interLATA services provided to businesses. Accordingly, the conclusions drawn above concerning the undesirability of government intervention in pricing decisions in competitive markets are fully applicable to business interLATA services.

<sup>26</sup> See for example Kahn, A., The Economics of Regulation: Principles and Institutions, Cambridge: The MIT Press 1988; Breyer, S. Regulation and its Reform, Cambridge: Harvard University Press 1982; Viscusi, W., Vernon, J. and Harrington, J. Economics of Regulation and Antitrust, 2<sup>nd</sup> Edition, Cambridge: The MIT Press 1995.

<sup>27</sup> "That is to say, the regulatory process—even when it functions perfectly—cannot reproduce the price signals that a workably competitive marketplace would provide. Thus, only serious market failure will, even arguably, warrant the adoption of cost-of-service ratemaking as a cure." Breyer, op. cit. p-59. See Viscusi, W., Vernon, J. and Harrington, J op. cit. chapter 2 for a discussion of the costs of the regulatory process.

whereas challenge in the regulatory forum is based on criteria established by regulators, which are seldom consistent with competitive responses in the marketplace.<sup>28</sup>

43. In addition to direct costs, regulation of competitive markets can impose indirect costs by detrimentally affecting innovation and investment. For example, a firm may decrease investment spending if the firm is not allowed the flexibility to fully take advantage of the benefits the firm expects to obtain from the investment.<sup>29</sup> Reducing investment and innovation in the short-term has long-term implications for consumer welfare. For instance, if firms fail to adequately invest in the development of new products and services in the short-term because they are concerned that regulators will control how the firm can price the products and services, the public will not reap the benefit of a market characterized by a broad range of products and services.

44. Further, in competitive markets characterized by rapid changes and changing fixed costs, it is critical that regulators permit companies the flexibility to structure their charges.<sup>30</sup> The ability of a firm to respond rapidly to competitive challenges is critical to the firm's ability to survive and thrive in a competitive marketplace. Without the ability to tailor plans to costs and consumer preferences, companies cannot pursue their vision and provide the services consumers demand. Failure to do so provides opportunity for other firms to undercut their prices and steal market share. Intrusive regulation that stunts the ability of firms to creatively provide attractive packages of services to their current and potential customers blunts the competitive process.<sup>31</sup> In doing so, regulation not only harms the firms involved, but more importantly can harm the consumers it is intended to benefit.

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<sup>28</sup> Kahn, op. cit. Chapter 6 and throughout compares the different standards for pricing by a regulated firm with the ability of a competitive firm to price its services.

<sup>29</sup> See Owen, B. and Rosston, G. "Effects of Unbundling Proposals on Cable Investment Incentives," The Party Line, Newsletter of the Communications Industry Committee, American Bar Association Section of Antitrust Law, March 1999.

<sup>30</sup> It is important to note that the discussion in this section explicitly refers to competitive markets. When markets are not competitive because a firm has market power, the tradeoffs in assessing the costs and benefits of regulation change.

<sup>31</sup> "In a competitive industry, firms are motivated to produce efficiently—to find ways to cut production costs—by the hope of increased profits and by the fear that failure to keep costs low will cause more efficient firms to capture their customers by lowering price. In a regulated industry, the stick is usually unavailable." Breyer, op. cit. p-47.

45. By contrast, the cost-based pricing imposed on markets by competition leads to the lowest possible prices and the efficient use of resources, which benefits consumers. If firms in a competitive market do not offer the lowest prices, customers will shift to alternative providers and the firms will be forced to lower their prices or exit the business. This drives prices to costs, which sends accurate signals to consumers and investors. Consumers purchase services when they value the services more than the services cost to provide. If the price of a service is above its cost, consumers will consume too little of the service. For example, the historical overpricing of long-distance services has led to an underutilization of long-distance. As competition has increased and prices for long-distance service have declined over the past 15 years, usage has increased significantly. The BLS 'Interstate Toll Service' Price index has decreased from 101.3 (January 1984) to 74.7 (January 1999). At the same time, long-distance access minutes have risen from 37.5 billion in 1984 to 520.1 billion in 1998.<sup>32</sup>

**B. The Long-Distance Industry is Competitive and Rapidly Changing**

46. The long-distance industry has changed significantly since 1984, and is now highly competitive. In 1984, AT&T was the dominant long-distance provider, equal access was just beginning, very few customers were aware of dial-around long-distance services, and the Internet did not exist. In the ensuing 15 years, aggressive competition has become the hallmark of the long-distance industry. AT&T's share of interstate minutes has declined from 83.0% (1985Q1) to 51.5% (1998Q4).<sup>33</sup> Although AT&T has lost market share across the board, competition has been particularly vigorous for business and high-volume residential customers because these customers historically generated the largest profits. Competition has been less intense for low-volume residential customers because they generate significantly less revenue and profit per customer.

47. The intense competition for profitable customers forces long-distance companies to price services for these customers very low. For example, AT&T offers a calling plan priced at seven cents per minute 24 hours a day, seven days a week. In addition, Sprint, MCI, and AT&T offer pricing plans which charge five cents per minute during evenings and weekends. There are numerous other, well-publicized long-distance

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<sup>32</sup> Long-distance Market Shares, Fourth Quarter 1998, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, March 1999.

<sup>33</sup> Long-distance Market Shares, Fourth Quarter 1998, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, March 1999. AT&T's share of industry revenues has fallen even more rapidly.

pricing plans available to customers,<sup>34</sup> and consumers respond vigorously to these offers.<sup>35</sup>

48. Another way to measure the competitiveness of the long-distance market is to understand how consumers make use of their ability to switch providers. Both the long-distance companies and the Commission have used “churn” as a factor in assessing the competitiveness of long-distance telephone service.<sup>36</sup> Churn is a measure of how frequently the customers switch providers and usually is expressed as the percentage of customers that switch IXC’s each month or year. High churn demonstrates that consumers are exercising their competitive alternatives and that switching costs are sufficiently low to enable consumers to do so.

49. I have examined the churn for customers who were presubscribed to AT&T’s long-distance telephone service between July 1998 and June 1999. Of these customers, a total of 19.2%, or 1 in 5, switched providers at some point during the year. The churn data show that callers have the ability and willingness to switch long-distance providers, as the Commission has long recognized,<sup>37</sup> and are not “locked-in” to their

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<sup>34</sup> A variety of organizations claim to provide comprehensive comparisons of the long-distance plans offered by the numerous domestic carriers operating today. See e.g., TRAC: Telecommunications Research and Action Center <<http://www.trac.org/>>; Teligistics.com: Telecommunications Cost Control Specialists <<http://www.teligistics.com/index.html>>; Consumer Reporting Rates the Long-distance Companies (last modified June 17, 1999) <<http://www.diverdownusa.com/report.htm>>; www.PhoneRateFinder.com: Long-distance Rate Search Engine <<http://www.phoneratefinder.com/>> .

<sup>35</sup> Wall Street Journal, “Phone War Prompts a Record Number of Calls” September 7, 1999 (noting “unprecedented call volume in response to a flurry of new offers introduced in recent weeks.”).

<sup>36</sup> See In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended, *Second Report and Order*, 11 FCC Rcd 20730 (1996), at ¶ 21 (finding “high churn rate” among interLATA users indicative of the competitiveness of the long-distance market).

<sup>37</sup> See *id.* (“We conclude, consistent with the AT&T Reclassification Order, that the high churn rate among consumers of interstate, domestic, interexchange services indicates that consumers find the services provided by interexchange carriers to be close substitutes, and that consumers are likely to switch carriers in order to obtain lower prices or more favorable terms and conditions.”) (citations omitted).

current provider. (In other words, all of those dinner-time telemarketing calls are effective.) The churn data also demonstrate that customers have meaningful competitive alternatives. Further, the ability and willingness of long-distance customers to switch providers is not limited to high-volume subscribers. In fact, AT&T data concerning its own residential customers show that customers with average monthly bills below \$10 switched long-distance service providers more often in 1998 than customers with bills between \$10 and \$25.

50. The long-distance market also has changed in other competitively significant ways, and these dramatic changes will increase the need for long-distance companies to provide flexible and attractive pricing plans to their customers. Consumers' use of dial-around services has increased significantly making it increasingly difficult for presubscribed IXCs to cover the fixed costs of serving their customers. This difficulty is compounded by the increase in additional fixed charges, such as the PICC, unless the presubscribed IXC is able to charge fixed monthly fees to its customers. Unlike presubscribed IXCs, dial-around providers are not compelled to cover the PICC charges in their per-minute rates and therefore are able to charge cost-based rates for each call. If presubscribed carriers are not allowed to charge flat-rated fees to customers to recoup PICCs, the carriers must increase their per-minute rates to cover this fixed cost. As a result, customers may use a dial-around company that offers cheaper per minute rates to place long-distance calls, rather than the customer's presubscribed IXC, and thereby avoid the higher rates the presubscribed carrier would be forced to charge to cover its fixed per line costs.

51. Most people expect significant changes in communication to be caused by the exponential growth of the Internet. The Internet's impact on long-distance telephony will provide another competitive avenue for long-distance customers. IP telephony and data transmission changes the cost structure of long-distance communications compared to traditional dial-up circuit switched communications. One recently published study reports that IP telephony usage will grow by a factor of 40 over the next 5 years.<sup>38</sup> This rapid increase is driving the expansion of companies like Qwest and Level 3 Communications. Qwest already has a market value of \$21 billion and Level 3 has a market value of \$22 billion even though neither company has a completed long-distance network or significant market share. This compares to market capitalization of \$40 billion for Sprint, which has a much higher current market share and also has a local exchange business. Qwest and Level 3's large market capitalizations indicate that the market expects these companies to grow more quickly in the future than established long-distance companies. In addition, the significant increase in bandwidth brought to the

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<sup>38</sup> Total Telecom, "IP Telephony to Climb 40-Fold In 5 Years,"

<http://www.totaltele.com/secure/view.asp?ArticleID=23675&pub=tt&categoryid=626>.

market to satisfy data transmission demands also will increase the transmission capacity available to provide voice services. Given the relatively low incremental cost of bandwidth and the low bandwidth necessary to transmit voice calls, this may change the structure of pricing for long-distance services.

C. None of the Individual Proposals on Which the Commission Requested Comment Are Necessary to Protect the Public Interest and Imposition of These Additional Regulatory Proposals Will Harm Consumer Welfare

52. In its NOI, the Commission requested comment on a variety of specific proposals. As explained above, there is no basis in economic theory to impose regulations on competitive markets and the long-distance market is highly competitive today. This section examines each of the Commission's proposals and demonstrates that none of the proposals are warranted by market failures in the long distance industry. Further, this section also discusses the detrimental effects that likely would result from enactment of these proposals by the Commission.

1. MURs are an economically efficient way of allocating costs among customers

53. The Commission asks in its NOI whether MUR's are "justified" and "appropriate."<sup>39</sup> Based on economic theory, AT&T's imposition of a MUR on low-volume subscribers is economically efficient because it closely aligns AT&T's cost of providing service to these customers with the rates AT&T charges the customers. Cost-based pricing is important for the static allocation of resources and also for dynamic signals for investment and innovation. When prices mirror costs, consumers receive an accurate signal about the cost of their use of a resource. If prices are not in line with costs, then consumers might over or under use resources. Cost-based prices also provide accurate signals for investment. If prices are not cost-based, firms will tend to over-invest or under-invest in cost-saving innovation. The combination of the MUR with the reduction in per-minute prices causes long-distance pricing to be more cost-based and consistent with the fixed costs of serving customers.

54. Specifically, AT&T's MUR is structured to cover the fixed cost of serving a customer.<sup>40</sup> Fixed costs, which do not vary with the volume of calls made by a

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<sup>39</sup> NOI, ¶¶ 13, 15.

<sup>40</sup> Note that the textbook definition of a perfectly competitive market posits that firms have no fixed costs because the firms operate in the long run. In an industry where there are fixed or sunk costs, firms will only enter a market if they believe that they will be able to not only cover their marginal costs, as in a perfectly competitive industry, but also to cover their fixed and sunk costs.



customer, include billing and collection, customer service availability, and customer acquisition and retention. In addition to the fixed cost of providing service to each customer, there also are significant fixed costs attributable to the development and maintenance of each long-distance network—the rights of way, the fiber, and the switching infrastructure which comprise a long-distance network all have significant fixed cost components. These fixed costs exist even if no calls are made by any customer. Moreover, all customers benefit from the network, regardless of their actual usage of the network, because the network provides each customer with the option of making a call to anywhere on the network.

55. In fact, to fully recover all of the fixed costs AT&T incurs to serve low-volume customers, AT&T's MUR would have to be higher than it is. I examined AT&T rate plans to understand the relative contributions that customers with different calling volumes make to AT&T's funding of fixed and common costs of the network. This analysis reveals that high-volume users, or more precisely those users who choose a plan tailored to high-volume users, generally contribute more on a per-customer basis to AT&T's fixed and common costs than do low-volume users. Prices that are above marginal cost generate a "contribution" to cover the fixed and common costs of a firm. There are numerous ways for firms to cover fixed costs—fixed charges, per unit charges, and other combinations of charges. AT&T offers a variety of rate plans at any point in time—the Basic Schedule that has a MUR but no monthly fee; several different variants of the AT&T One Rate® plan for which AT&T charges a monthly fee; other plans which target specialized markets; and a plethora of promotional offers. I compared contribution to per customer fixed costs from the basic AT&T One Rate® with the contribution from the AT&T One Rate® 7¢ Plan<sup>41</sup> to determine whether the MUR fully recovers the fixed cost of providing long-distance service to low-volume customers.

56. For purposes of this illustration, it is simplest to assume that marginal cost is seven cents a minute, although the import of my analysis would not change if a different assumption were used.<sup>42</sup> A caller with zero minutes of use would generate a

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<sup>41</sup> The same exercise could be done with AT&T's Basic Schedule rates, but the differing rates for different times of day make the exposition more complicated. The conclusions stated above would still hold true.

<sup>42</sup> The results of my analysis are insensitive to the choice of seven cents per minute as the marginal cost because the analysis is a comparison between the levels of contribution to fixed costs of the two plans. For example, if the marginal cost were five cents per minute, then each customer would generate an extra two cents per minute of contribution to fixed costs. However, because when comparing the two plans we are assuming that our hypothetical customers are using the same number of minutes, that additional two cents per minute drops from the comparison.

contribution of \$5.95 per month if she signed up for the AT&T One Rate® 7¢ Plan, because that is the amount of the monthly fee.<sup>43</sup> With zero minutes of use, a AT&T One Rate® Plan customer would generate \$3 of contribution, because she would pay no monthly fee, be charged a 15 cent per minute rate, and be subject to a \$3 MUR. Up to 75 minutes of use, the contribution to fixed costs from the AT&T One Rate® Plan customer would be less than the contribution from the AT&T One Rate® 7¢ Plan customer. For example, at 50 minutes of use, the basic AT&T One Rate® Plan customer would be contributing  $(15¢/\text{minute} - 7¢/\text{minute}) * 50 \text{ minutes} = \$4.00$ , while the AT&T One Rate® 7¢ Plan customer would still be contributing \$5.95. The cross-over point on the contribution under these assumptions is 75 minutes per month, after which point the AT&T One Rate® Plan customer would contribute more to the common costs. However, at that point, the rational thing for the consumer would be to subscribe to the AT&T One Rate® 7¢ Plan. Thus, rather than an inequitable and unjustified charge on low-volume users, AT&T's MUR actually causes low-volume users to contribute less per customer to AT&T's fixed costs than is contributed by higher volume customers who pay a monthly fee that is higher than the MUR.<sup>44</sup>

2. To reduce transaction costs, the PICC should be charged directly to customers by their local exchange providers

57. The NOI asks whether the PICC should be billed directly to customers, just as local exchange carriers bill the SLC<sup>45</sup> directly to customers.<sup>46</sup> Because the PICC and SLC both fund the federal portion of non-traffic sensitive loop costs, assessing these charges directly to customers on a flat-rated basis is appropriate. In fact, requiring local exchange providers to recover all of the costs of the local loop attributable to interstate calling is the most efficient way to recover these costs (subject to a price cap maximum,

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<sup>43</sup> If the customer also signs up for AT&T intraLATA toll service, the monthly fee drops to \$4.95.

<sup>44</sup> For purposes of this analysis, I have ignored the fixed costs of billing a customer, because they are very similar for high-volume and low-volume customers and thus including these fixed costs does not alter the end result. AT&T has attempted to minimize these costs where possible by implementing measures such as bi-monthly billing for residential customers with less than \$25 in monthly usage. In addition, there may be certain costs that are a function of total bill size, but these costs would then be related to per-minute costs, and would not be a true fixed cost.

<sup>45</sup> See, *supra*, note 6.

<sup>46</sup> NOI, ¶ 18.

until competition is sufficient to abolish even that).<sup>47</sup> Local exchange providers already bill their customers the SLC and a monthly flat-rated charge for the intrastate costs of the local loop. Because the PICC is essentially identical to the SLC, there is no economically justifiable reason to cause customers to incur the extra transaction costs that occur when long-distance carriers collect the PICC pass-through from customers and then pay it to local exchange providers.<sup>48</sup>

3. *The Commission should not interfere with the methods chosen by IXC's to recover the PICC and USF charges*

58. The Commission asks in the NOI for comment on whether it should prohibit long-distance companies from recovering the PICC and USF charges on a flat-rated basis, or require these charges to be recovered on a percentage basis.<sup>49</sup> Similarly, the Commission asks for comment on whether IXC's should be required to recover the flat-rated PICC charge through a percentage charge that is capped at a certain level, rather than as a flat-rated charge.<sup>50</sup> Such interference with the method used by competitors in a competitive market to set their prices is likely to harm rather than benefit consumers. The highly competitive nature of the long-distance market assures that IXC's will pass these charges through to their customers in an economically reasonable manner that is consistent with customer preferences.

a. *PICC*

59. The Commission's introduction of the PICC was intended specifically to replace inefficient per-minute regulatory charges with cost-causative per line charges, and thereby to accomplish long-distance rate reductions.<sup>51</sup> The introduction of the SLC and

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<sup>47</sup> The Commission recently requested comment on such a proposal. See Access Charge Reform, Notice of Proposed Rulemaking, CC dockets Nos. 96-262, 94-1, 99-249, 96-45, FCC 99-235 (rel. Sept. 15, 1999).

<sup>48</sup> These unnecessary transaction costs include additional costs incurred by the local exchange carriers to bill IXC's, costs of tracking and processing payments between the IXC's and local carriers, and IXC's' costs to bill and collect PICC pass-through charges from their customers.

<sup>49</sup> NOI, ¶ 19.g.

<sup>50</sup> NOI, ¶ 21.c.

<sup>51</sup> See Access Charge Reform, First Report and Order, 12 FCC Rcd 15982 (1997), *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8<sup>th</sup> Cir. 1998).

the PICC has led to a decrease in per-minute interstate access charges from more than 17 cents per conversation minute in 1984 to 3.7 cents per conversation minute as of June 30, 1999.<sup>52</sup> Since then, interstate access charges have continued to decrease. According to Regulatory Research Associates, Inc., BOC's access charges per conversation minute decreased from 3.17 cents to 2.07 cents per conversation minute with the July 1, 1999 access filings.<sup>53</sup> Prohibiting flat charges by IXCs would essentially eviscerate the progress in achieving cost-based access charges accomplished by ten years of access charge reforms.<sup>54</sup>

60. Regulatory movement away from cost causation causes significant loss to the economy. The large increases in long-distance minutes that were achieved as a result of reductions in long-distance prices are due at least in part to reductions in access charges. These reductions likely would not have been possible without increases in monthly charges to pay for the non-traffic sensitive costs of the local loop. The resulting higher monthly prices for local service have not caused subscribers to disconnect from the network according to the Commission's Penetration Report,<sup>55</sup> so the benefits of additional long-distance usage have not been offset by reductions in local service subscribership. Hence, the implementation of cost-based charges has been an important source of consumer welfare in telecommunications.

61. More specifically, most IXCs recover the PICC as a single, averaged flat-rated charge.<sup>56</sup> Preventing IXCs from recovering PICCs through flat charges would send

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<sup>52</sup> 1999 Trends in Telephone Service, Table 1-2.

<sup>53</sup> Publication: TeleFOCUS on September 1, 1999

<sup>54</sup> See Access Charge Reform, First Report and Order, 12 FCC Rcd 15982 (1997), *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8<sup>th</sup> Cir. 1998).

<sup>55</sup> According to the March 1999 Penetration Report there is 94% nationwide penetration. Although this represents a slight (0.2%) decline from the November 1998 penetration rate, the Penetration Report states that this decline is not statistically significant. "Telephone Subscribership in the United States," Federal Communications Commission, rel. May 1999, Table 1.

<sup>56</sup> Most IXCs charge a single, averaged PICC pass-through because until recently they did not (and in some cases still may not) receive sufficient information from ILECs to differentiate between primary and non-primary lines. The Commission has required ILECs to provide this information to IXCs. However, the PICC for primary and non-primary lines will converge in each ILEC's territory (on a staggered basis) over the next few years. As a result, many IXCs it may not have developed the billing capability to

incorrect signals to consumers and create implicit subsidies. Economic theory predicts that firms will pass through to their customers costs, such as the PICC, in the form that the costs are incurred by the IXC. If IXCs try to recover the PICC in another way, the IXCs open themselves to the possibility that a competitor will be able to offer a more attractive package to some of their customers, specifically those customers with prices that are too high. Competitors will avoid those customers whose prices are too low. In the long run, competitive firms cannot thrive if they lose profitable customers because of inefficient pricing.

62. In addition to the inherent inefficiency of passing through a per-line cost to customers via a per-minute charge, such an approach would create a new implicit subsidy. To permit IXCs to fully recover the PICC on a percentage basis with a capped maximum, the Commission would have to cap the percentage charge above the level of the PICC. Otherwise, the under-recovery from those customers whose calling volume is not sufficient for the percentage charge to equal the actual PICC would not be fully offset by high-volume users.<sup>57</sup> However, if the cap is sufficiently high, some IXCs might specialize in serving high-volume customers and charge them a lower percentage rate to recover the PICC, leaving other IXCs with too many low-volume customers to fully recover the PICC on a percentage basis.

63. For example, if the PICC were \$1.53 for all lines, and the Commission required IXCs to recover the PICC as a percentage charge capped at \$1.53, some low-volume consumers would pay less than \$1.53 in PICC surcharges. As a result, the IXC's total recovery would be less than \$1.53 per line and the carrier would be unable to fully recover its PICC expenses. To remedy this, the Commission would have to cap the PICC pass-through at a level above \$1.53, say at \$2.50. In that case, some higher volume customers would pay more than their PICC costs. Aggressive IXCs could capitalize on this anomaly by offering a special package with a reduced PICC pass-through percentage charge for which only high-volume customers would be eligible. High-volume customers might find such a plan attractive because they would no longer have to over-

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identify the status of their presubscribed customer's access lines because they did not find that the expense of doing so was warranted given the temporary nature of the disparity in the PICC for primary and non-primary lines. In any event, because the interLATA market is competitive, if carriers believe they can cost-effectively attract customers by charging a non-averaged PICC pass-through, they will presumably attempt to do so, and customers could then decide for themselves whether they valued this attribute.

<sup>57</sup> Besides the PICC, interexchange providers also must recover the transaction costs of collecting the PICC pass-through from customers, paying the PICC to local exchange providers, and uncollectable bills.

pay for the PICC. The IXC's stuck serving predominantly low-volume callers, who underpay their PICC pass-through charges, will be unable to offset their losses other than by raising rates. By mandating inefficient and avoidable pricing schemes, the Commission would create implicit subsidies and inefficient competitive incentives. The Commission can avoid these problems by refraining from adopting this suggestion.

64. Moreover, there are many different ways that long-distance companies could change their pricing plans to mimic a flat charge. For example, GTE and SNET both offer declining block pricing programs for interLATA service.<sup>58</sup> That is, they charge a high rate for the first set of minutes and then lower rates as a customer's calling volume increases. In essence, this is a way to charge per minute prices above marginal cost for low-volume users and set prices closer to marginal cost for high-volume customers. To prevent long-distance providers from adopting similar pricing structures, any Commission regulations would have to be far reaching and intrusive.

b. USF charge

65. The Commission asks for comment on whether it should require recovery of the USF charge on a percentage basis to mirror the assessment of this charge.<sup>59</sup> USF liabilities are determined based on telecommunications providers' revenues from the prior 6 month period. As a result, today's usage does not translate into the current liability, which is unknown because the Commission does not determine the universal service fees until after the quarter has ended. Most IXC's assess the USF charge to their customers as a percentage surcharge. However, the exact amount of the surcharge varies among IXC's because carriers have different cost structures for collecting the fees and serving customers, as well as different expectations about their liability in the coming

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<sup>58</sup> The SNET Automatic Savings Plan offers the following rates:

<u>Monthly Usage</u>	<u>Rate Per Minute</u>
\$50 and above	10¢
\$25 - \$49.99	12¢
Up to \$24.99	15¢

Source: [www.SNET.com](http://www.SNET.com)

GTE Easy Savings Plan Discounts offer the following declining block pricing discounts:

\$0 to \$9.99 a month	0%
\$10 to \$24.99 a month	10%
\$25 or more a month	25%

Source: [www.GTE.com](http://www.GTE.com)

<sup>59</sup> NOI, ¶ 19.g.

period. As a result, even if the Commission were to require collection on a percentage basis (which it shouldn't), the Commission still should not mandate the level of the charges because each firm incurs different administrative costs to collect the charges and has different future revenue expectations.

66. AT&T has decided not to pass through USF charges to its residential customers on a percentage basis for several reasons.<sup>60</sup> AT&T based its business decision to use a flat-rated charge to pass through the USF charge to residential customers on business considerations, including the expense of modifying its billing system to calculate a percentage-based USF charge, the difficulty in determining what the pass through percentage should be given the volatile nature of AT&T's revenues and customer preference as determined by a survey of residential customer preferences undertaken on behalf of AT&T.

67. AT&T engaged an independent research firm to conduct a customer survey of AT&T's residential customers to assist AT&T in evaluating the best method of passing through USF charges to its customers. In that survey, the research firm divided customers into three groups based on calling volume and presented them with four different combinations of flat charges and percentage charges, each designed to provide the same overall revenue. All three usage groups preferred a flat-rated charge to a percentage charge. In addition, AT&T examined the preferences of those above 55 years of age and by income level. Again, each age category and income level preferred fixed to percentage charges. AT&T's flat-rated USF charge is one way that AT&T differentiates itself from its competition.

68. AT&T customers that would prefer to be assessed a USF charge on a percentage basis can switch to one of the many IXC's that bill the USF charge in this manner. As a result of the competitiveness of the long-distance, the market, consumers have a variety of USF billing alternatives. If the Commission mandated that IXC's only assess the USF charge on a percentage basis, many consumers would not obtain their preferred outcome. If AT&T assesses a percentage-based USF charge in the future, competition and consumer preferences should cause this result, not regulation.

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<sup>60</sup> Each of AT&T's business units determined how to pass through the USF charge to their customers based on their analysis of relevant business considerations, including the costs of developing the necessary capabilities in each of their billing systems. In most cases, AT&T assesses USF surcharges on its business customers on a percentage basis, while AT&T Wireless Services uses a flat-rated charge.

4. Combining all federally mandated charges

69. The Commission asks in the NOI whether it “should consider requiring carriers to combine charges associated with all of our pro-competitive reforms into a single line item...”<sup>61</sup> Such a requirement conflicts with most principles of economics and competition. First, it would require lumping together of charges that might be flat-rated with those that vary as a percentage of use. As a result, it might force non-cost based pricing. If a carrier were required to combine these charges as a percentage surcharge or a flat-rated charge, the carrier might not be able to efficiently recover the regulatory charges. As a result, some customers would be overcharged and some undercharged, or there might be an inefficient sorting of customers among carriers based on the structure of their charges.

70. Sometimes companies choose to have limited deviations from cost-based pricing, often to cater to consumer preferences. But choices to deviate from cost-based pricing by competitive firms can only last as long as consumers and competitors allow. In a competitive market, firms will find a way to provide attractive, cost-based packages. Forcing firms away from their own choices while at the same time preventing cost-based pricing would obfuscate the signals consumers receive, and cause consumers to respond in a way that fails to efficiently utilize societal resources. Finally, such a requirement would conceal the nature of the charges paid by consumers. Information is critical in competitive markets—including information concerning the social programs for which consumers are paying. A regulatory body should not mandate obfuscation.

5. Attempts to regulate long-distance pricing

71. The Commission also asks in its NOI for comment on whether “if it is demonstrated that IXCs are recovering more than their USF or PICC contributions through end-user charges, the Commission can and should correct such over-recovery and, if so, how.”<sup>62</sup> Merely posing this question does more harm than good. By inviting consideration of schemes to punish competitive companies, the Commission creates an incentive for competitors to use the regulatory system to harm the entire competitive process. Rather than aggressively competing in the marketplace to serve customers, such an approach provides an incentive for firms to bring complaints to the Commission in hopes that they will gain an opportunity to investigate their competitors’ books. Such regulatory oversight is unnecessary in the competitive long-distance market.

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<sup>61</sup> NOI, ¶ 25.

<sup>62</sup> NOI, ¶ 19.f.



72. “Correcting such over-recovery” would require a rate case hearing to determine whether interexchange charges are reasonable. Rate case hearings may be appropriate when a firm is regulated because it has a natural monopoly, but are totally inappropriate in a market with numerous competitors. A rate case hearing would expose competitively sensitive information that would hamper the competitive process. The Commission has almost no information on the costs of providing long-distance service. To obtain such information by revivifying the long dormant regulatory apparatus necessary to accurately understand and to govern the long-distance business would be a massive undertaking. By the time the hearing process is completed, the industry likely will have undergone sufficient changes and the results of the hearing will be meaningless. Finally, any Commission effort to re-regulate the long-distance industry would be inconsistent with the Commission’s current efforts to eliminate nondominant domestic interexchange tariffs altogether.<sup>63</sup> The tension between these two approaches cannot be reconciled. It is clear that regulation of long-distance pricing is the wrong approach, and would impose costs on consumers without creating any corresponding benefits.

73. The NOI also asks whether the Commission’s local number portability (“LNP”) cost recovery regime provides a precedent that might justify regulation of interLATA pricing or recovery.<sup>64</sup> To the contrary, in that proceeding the Commission required incumbent LECs with market power to file tariffs and provide cost support to justify their LNP-related charges. The Commission did not require tariff or cost recovery filings of any kind by non-ILECs—and there would have been no reason to seek cost support from firms without market power. The same is true in the long-distance market.

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<sup>63</sup> In 1996 the Commission ordered all nondominant, domestic interexchange carriers to cease tariffing their services. Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended, *Second Report and Order*, 11 FCC Rcd 20730, at ¶ 27 (1996). However, several parties appealed this order to the United States Court of Appeals for the D.C. Circuit and the court stayed the detariffing order while the Commission reviewed the order pursuant to a petition for reconsideration. MCI Telecommunications Corp. v. FCC, 1997 U.S. App. LEXIS 41382 (D.C. Cir. Feb. 13, 1997). On reconsideration, the Commission upheld its initial determination, and that order is now pending before the D.C. Circuit. Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended, *Order on Reconsideration*, 12 FCC Rcd 15014 (1997).

<sup>64</sup> NOI, ¶ 24.

6. Affordability

74. The NOI seeks for comment on “whether the definition of ‘affordability’ under section 254 should allow a customer who ordinarily makes few long-distance calls to avoid MURs or unreasonably high usage rates.”<sup>65</sup> As discussed above, there is only a small correlation between low use and income. As a result, regulations aimed at shielding low-volume users from MURs or high per-minute rates would benefit high-income customers much more than low-income customers because low-income customers already are insulated from MURs by the AT&T Lifeline Program. In addition, it is impossible in a competitive market to have it both ways—the Commission cannot prohibit MURs without causing corresponding increases in per-minute rates to cover the fixed monthly costs that would otherwise be covered by the MURs. Mandating a particular rate structure may not only lead to inefficient cost recovery, but also can increase a consumer’s bill. Any regulator must consider not only the direct cost of implementing a regulatory program, but also its implementation costs and the costs arising from inefficient rate structures.

7. Additional requirements for long-distance providers

75. The Commission also asks in the NOI whether it “should require all or some subset of IXC’s” to comply with certain regulatory proposals.<sup>66</sup> The Commission should not differentially intervene in a competitive marketplace. The Commission for years has been moving away from differential regulation of IXC’s, and any proposal to require actions of a “subset of IXC’s” would be regressive and wrong. Since the Commission has declared AT&T non-dominant and abolished the “equal charge per unit of traffic” rule, it has not sought to grant favored regulatory status to any segment of the long-distance industry. This is the correct approach. No regulations applicable to the long-distance industry should single out large, small, or any other type of long-distance company.

8. Requirement to maintain rate plans without MURs

76. The Commission asks for comment on whether it should mandate that IXC’s maintain rate plans that do not include an MUR.<sup>67</sup> As I have shown, such a requirement would require carriers to offer rate structures that are not based on either

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<sup>65</sup> NOI, ¶ 19.c.

<sup>66</sup> NOI, ¶ 21.

<sup>67</sup> NOI, ¶ 21.a.

costs or consumer preferences. In other words, carriers could be forced to charge inefficient prices, or to fail to fully recover all of their costs. In addition, there are hundreds of long-distance providers each offering multiple rate plans. Some plans carry no MUR, whereas others do. It is not clear that consumers would benefit from requiring all carriers to offer similar rate plans. Indeed, requiring all firms to offer plans with no MUR might lead to perverse results that would harm consumers. Just as GTE and SNET have declining block pricing, if the Commission were to require firms to offer pricing plans with no MUR, long-distance companies might offer such a plan, but charge \$5 for the first minute. Although this might satisfy the Commission's concerns, it would affect low-volume customers in essentially the same fashion as an MUR.

77. The Commission also asks whether there are other industries with minimum usage requirements or flat-rated charges that apply regardless of usage.<sup>68</sup> The economy is replete with such examples. The most obvious is the local exchange industry. Every local exchange customer pays a flat monthly rate regardless of usage. Wireless carriers generally also have similar requirements.<sup>69</sup> Many electricity and natural gas utilities also impose minimum monthly charges. Other examples include "warehouse club" type stores, banks, ISPs, country clubs, credit cards, and gyms. These types of charges are prevalent throughout the economy, and often apply to other "necessities" such as electricity and gas. A table of these types of charges is attached as Exhibit 2.

9. Access charges

78. The Commission also sought comment on whether IXCs should be required to pass through a specific portion of access charge reductions to their basic rate plans. In a static world without any preexisting subsidies, one would expect perfect and transparent pass-through of access charges in all rates. However, the telecommunications market is incredibly dynamic and there are many changes occurring daily. As a result, isolating the effect of access charge changes on specific customers or groups of customers is very complicated.

79. A simple example can help to illustrate this point. Assume that a long-distance provider initially has two customers: customer A, who makes many calls, and customer B who makes no calls. Assume that both customers subscribe to their IXC's basic rate plan. If access charges fall, the customers' long-distance provider will offer a

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<sup>68</sup> NOI, ¶ 26.

<sup>69</sup> Some wireless carriers offer pre-paid plans that only charge on a per minute of use basis, but those plans often expire within a set period of time, effectively constituting an MUR.

more attractive package of per minute long-distance rates. Customer A is likely to select the package to benefit from the access charge reductions. The self-selecting nature of the change in the non-basic package may reduce the profitability of the basic rate plan because customers remaining on the basic rate plan, such as customer A, have lower calling volumes. Therefore, it becomes more difficult for the long-distance provider to cover its fixed monthly costs from customers remaining on the basic rate schedule. As a result, prices continue to be in line with costs even though there is no reduction in the basic rate schedule in response to access charge reductions.

80. To illustrate this with real world data, AT&T and others have recently introduced new, low per minute rate plans. Given the monthly fees associated with these plans, I expect them to attract relatively more high-volume long-distance users.<sup>70</sup> If this is true, the customers who remain on the other rate plans will have lower usage than the typical customer did prior to the introduction of the new package. As a result, the other rate plans will generate fewer revenues and probably will be less profitable (or even more unprofitable) than previously. As a result, the per-minute prices in the pre-existing plans may not decline in order to offset the lower usage. Only those customers who were willing to switch plans would benefit from the access charge reductions.

81. In addition, because of all of the changes occurring at the same time, it would be very difficult to determine whether access charges reductions are being passed through directly to each customer. As customers select different calling plans, the dispersion of access reductions will be offset by the changing characteristics and costs of serving the remaining customers. Returning to rate regulation would require numerous accounting and disclosure procedures and would be extremely complicated, burdensome, and expensive to implement. Even then, it is unlikely that the Commission would be able to determine with certainty whether access charge reductions are being passed through to subscribers.

82. However, it should be noted that in a competitive market, prices inevitably will change to reflect changes in costs. As a result, consumers ultimately will benefit from per minute access charge reductions. If customers are not satisfied with the price reduction they receive from AT&T, they can and should seek a preferable rate plan from another carrier. Because the long-distance market is fully competitive, access charges reductions will be passed through to consumers without Commission action, and Commission interference is therefore unnecessary.

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<sup>70</sup> Not all subscribers will be high-volume customers, especially in a given month, as they may have varying calling patterns.

10. Consumer education

83. The Commission also seeks comment as to whether it should require consumer education inserts to be included with bills. Plainly, information about competitive alternatives is very important to the operation of a competitive market. If consumers do not know about their choices, they may not have the best long-distance plan.

84. The Commission does not need to require bill inserts or any other type of mandatory disclosure of competitor's terms. The competitive marketplace, however, provides significant information to consumers.<sup>71</sup> The additional information resulting from mandating educational inserts requirement probably would not enable consumers to make more educated choices. As I discussed earlier, long-distance companies spend huge amounts of money to inform customers about their services. These efforts are specifically designed to attract customers whereas an educational insert might not make plans look attractive enough to entice consumers to switch.

85. In addition, requiring such bill inserts could easily lead to demands by competitors for inserts in bills of local exchange providers, cable service operators, and cellular operators. This is a slippery slope and could lead to significant additional regulation rather than competition.

11. Ex post regulatory intervention

86. The NOI asks whether the Commission should intervene if a customer *ex post facto* has chosen the wrong calling plan.<sup>72</sup> There is simply no basis for such extraordinarily intrusive regulatory intervention, as even a cursory consideration of this issue shows. Using similar logic, if last year I did not have any accidents in my car, my state Insurance Commissioner could require my insurance company to refund a portion of my insurance payments because I would have been better off with less (or no) auto insurance coverage.

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<sup>71</sup> In fact, Chairman Kennard has already issued a statement encouraging consumers to avail themselves of the abundance of information and to shop for long-distance service. The statement then provides consumers with information about how to do so. See "FCC Chairman Reminds Consumers to Shop Around," April 9, 1999. [http://www.fcc.gov/Bureaus/Miscellaneous/News\\_Releases/1999/nrmc9017.html](http://www.fcc.gov/Bureaus/Miscellaneous/News_Releases/1999/nrmc9017.html).

<sup>72</sup> NOI, ¶ 26.

87. There is no reason for the Commission to interfere *ex post* when consumers are made fully aware of their options as a result of the aggressive advertising that is occurring today in the competitive long-distance market. Consumers make informed choices about what they *expect* will be best for them, and they must be permitted to do so in order for the market to function. In addition, the *ex post* approach the NOI suggests would increase the fixed costs of serving each customer, because all IXC's would have to put in place a non-usage sensitive apparatus that monitors all customers bills and assigns them to the most beneficial rate plan. This increased cost would have to be offset by increased fixed charges for customers, and probably by increased per minute rates as well, making any such initiative self-defeating.

12. Regulatory protections for low-volume customers

88. There are existing Lifeline programs to assist low-income households to obtain local telephone service. With the introduction of the PICC, AT&T introduced its own form of Lifeline service to eliminate the flat-rated charges and monthly MUR for qualifying low-income consumers. If the Commission requires such a program, it should fully fund the program rather than relying on carriers' corporate goodwill.

89. The Commission asks whether similar protections should be created for low-volume customers who do not qualify for Lifeline assistance (that is, who can fully afford to pay for telephone service).<sup>73</sup> Another way of characterizing this question is to ask whether it is reasonable to subsidize second lines and lines in vacation homes, or high-income households that happen to make few long-distance calls. There is no reason to do so. As discussed earlier, these customers are in little danger of disconnecting from the network, there is no public interest benefit in subsidizing their telephone usage, and they probably can avoid an MUR by combining their bills. In addition, such requirement would *increase* rates for other customers who might be in danger of being disconnected. This is precisely the type of solution the Commission must avoid if the Commission's objective is to promote efficient and equitable telecommunications policy.

**VI. LOCAL COMPETITION AND SUBSCRIPTION EFFECTS**

90. The NOI asks whether the entry of regional Bell Operating Companies ("BOCs") "will mitigate the problems currently experienced by low-volume long-distance users."<sup>74</sup> BOC entry will not benefit consumers until the BOCs have satisfied the market-opening requirement of the 1996 Act. Premature entry will harm consumers,

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<sup>73</sup> NOI, ¶ 23.

<sup>74</sup> NOI ¶ 17.

especially low-volume customers, because their local phone bills comprise a large proportion of their telecommunications expenses.

91. The “primary focus of the Commission’s inquiry concerns flat-rated charges attributable to universal service and access charge reform.” However, admitting additional competitors to the already competitive interLATA market cannot meaningfully address the Commission’s concern because the new entrants also would be subject to these same charges. Admitting new competitors with the same fixed costs will not result in a reduction in the PICC pass-through and USF charges.

92. Clearly more competition, especially from efficient providers, would benefit consumers. The best way to achieve additional competition in telecommunications, however, is to ensure that local exchange markets are opened to competition so that consumers can obtain local, long-distance, and bundled services from a variety of carriers. To date, the Commission has not found that any BOC has met the standards imposed by Section 271 of the 1996 Act by demonstrating that it has completely opened its market to competition. Congress envisioned that long-distance approval would provide an incentive for BOCs to open their local markets. If this incentive is removed by permitting BOCs to enter the long-distance market without fully satisfying the requirements of Section 271, the BOCs will have essentially no incentive to satisfy the local exchange entry requirements, thereby making local competition less viable. As Congress recognized, the ability of long-distance providers to include a local service product in a bundled offering will benefit consumers. In fact, when AT&T is the local service provider, its customers automatically avoid the \$3 MUR.

93. Even when local markets are fully open to competition, enabling BOCs to provide long-distance and IXC to provide local service, consumers still will be forced to pay the costs of such services, including regulatorily mandated charges like the PICC pass-through and USF charges. For example, even though they have not met the market-opening requirements of section 271, GTE and SNET are able to provide long-distance service. Both companies charge their customers a PICC pass-through and USF charge. GTE also charges a separate MUR for long-distance when it is not a customer’s local carrier.<sup>75</sup>

94. In any case, low-volume customers would benefit little from any reduction in their long-distance bills because their long-distance charges are, by definition, minimal—particularly in comparison to the charges they pay for local telephone service. For a typical customer, local exchange service costs approximately \$20 per month, whereas most of the charges imposed on a low-volume long-distance customer are

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<sup>75</sup> See for example the rate plan described at <http://www2.gte.com/LD/rld/total.cfm>.

comprised of the PICC pass-through and USF charge. These fixed costs will not be reduced or otherwise affected by the pass through of access charge reductions by IXC's.

95. The NOI is also concerned with the effect on penetration or subscribership. Converting per minute access charges to PICC charges and adding USF payments and MURs all could increase some customers' bills somewhat, but will have minimal (if any) effect on telephone penetration. Econometric evidence of the elasticity of demand for local phone service has consistently shown that subscription is very insensitive to the level of MURs or fixed monthly charges.<sup>76</sup> While the PICC pass-through, USF charges, and MUR all are included on the consumers' long-distance bills, their effect on customers' subscription decisions should be similar to that observed due to changes in the customers' monthly local exchange bills to the extent that the long-distance bills are comprised of fixed monthly charges and MURs.<sup>77</sup>

96. The Commission's data on telephone penetration support the above analysis. Since 1992, the overall nationwide penetration has only varied by 0.5%, from a low of 93.7% penetration to a high of 94.2% penetration. The most recent estimate of penetration in March 1999 was 94.0%.<sup>78</sup> Since the flat charges at issue in the NOI were introduced, the Commission's data show that there has been no statistically significant change in penetration.<sup>79</sup>

97. The demographic data presented in section 2 above also are useful for evaluating the effects on subscribership. Hausman, Tardiff and Belinfante present results

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<sup>76</sup> See Taylor, Lester, Telecommunications Demand in Theory and Practice, Dordrecht: Kluwer Academic Publisher, 1994, chapter 5, Garbacz, Christopher, and Thompson, Herbert Jr. "Assessing the Impact of FCC Lifeline and Link-Up Programs on Telephone Penetration," *Journal of Regulatory Economics*, vol 11 (1997), pp 67-78. For a summary of other recent articles, see Crandall, Robert and Waverman, Leonard, "Who Pays for 'Universal Service'? When Telephone Subsidies Become Transparent," *unpublished manuscript*, 1998, Ch 1.

<sup>77</sup> To the extent that long-distance companies cannot disconnect local service for nonpayment of long-distance charges, the effect on subscribership will probably be lower than even the low estimates for local charges.

<sup>78</sup> "Telephone Subscribership in the United States," Federal Communications Commission, rel. May 1999, Table 1.

<sup>79</sup> "Telephone Subscribership in the United States," Federal Communications Commission, rel. May 1999



that show that not only is the elasticity of demand low with respect to the monthly telephone bill (which would include flat-rated charges for long-distance service), but also that subscription decisions are sensitive to per minute long-distance rates.<sup>80</sup> In other words, subscribers disconnect because of high toll rates as well as high monthly rates. As a result, any attempt to lower fixed charges at the expense of higher per-minute rates will have not only have distributional effects, but may not be effective. The distributional effects would include transfers from low-income to high-income subscribers as shown in section 2. This is unlikely to help increase or maintain high telephone penetration since penetration is highly correlated with income.<sup>81</sup>

## **VII. CONCLUSIONS**

98. The NOI appears to challenge a fundamental tenet of economic theory that it has long embraced in other contexts—that competitive markets assure efficient pricing and allocation of resources, and provide consumers with the greatest utility. The Commission requests comment on a variety of intrusive regulatory proposals without even suggesting that any market failure has occurred to warrant such interference. As the Commission itself has affirmed, the long distance market is highly competitive. In a competitive market, price regulation does not benefit consumers and, in fact, is often detrimental to consumer welfare. Price regulation in competitive markets causes prices to deviate from the competitive optimum and thereby sends inefficient price signals that distort the behavior of consumers, competitors, and capital markets.

99. Long-distance providers compete aggressively to offer consumers superior prices and services. The competitive nature of the market provides a rapid, dynamic discipline for firms that try to overprice their services, and regulations that dictate prices, terms or pricing structures will interfere with this competitive dynamic. It is a bedrock principle of economic theory that in a competitive market consumers will benefit from efficiently priced services that reflect customer preferences. The Commission should continue to permit the long-distance market to accomplish this result by assuring long-distance competitors the flexibility to tailor their offerings to best serve the needs of consumers in this rapidly changing and highly competitive market. The breadth of pricing plans and alternative carriers currently available to consumers and the substantial

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<sup>80</sup> Hausman, J., Tardiff, T. and Belinfante, A., *The Effects of the Breakup of AT&T on Telephone Penetration in the United States*, AMERICAN ECONOMIC REVIEW. (May 1993): pp. 178-184.

<sup>81</sup> “Telephone Subscribership in the United States,” Federal Communications Commission, rel. May 1999, Table 4.

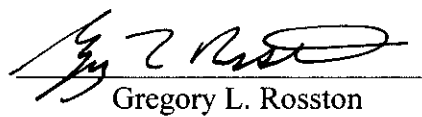
drop in long-distance rates over the past five years demonstrates that competitive forces in the long-distance market are successfully fulfilling this role.

100. Further, the Commission's apparent concern that low-volume and low-income consumers are somehow being disadvantaged by the long-distance industry's decision to pass costs through to consumers on a flat-rate basis is misplaced. Specifically, my analysis of AT&T's customers' billing records demonstrates that, in terms of household income, low-volume callers are similar to all other long-distance users. Thus, low-income long-distance customers are not disproportionately affected by flat-rated charges. In addition, AT&T has implemented a variety of measures to ensure that the recent changes to its billing practices will not have a significant impact on its low-volume subscribers, and, in particular, its low-income subscribers. By aggregating all of their AT&T services onto a single bill, enrolling in alternative calling plans, or utilizing online billing, all of AT&T's low-volume subscribers can lessen or eliminate the impact of the MUR. Moreover, AT&T's self-funded AT&T Lifeline Program, for which over five million households are eligible nationwide if they subscribe to AT&T's long-distance service, waives all flat-rated charges for low-income subscribers, including the federally mandated PICC pass-through and USF charges and the MUR. The competitive long-distance market also offers AT&T's customers numerous alternatives to AT&T's pricing plans, while simultaneously forcing AT&T to continue to offer pricing plans that conform to its customer's preferences.

101. To truly benefit low-volume long-distance users, as well as all other consumers, the Commission should focus its attention on opening local exchange markets to competition. Low-volume long-distance users' local exchange carrier's bills are far higher than their relatively insignificant long-distance bills. By promoting competition in the local exchange, the Commission can benefit all consumers, including low-volume long-distance customers. By contrast, allowing the BOCs to prematurely enter the long-distance market will substantially harm consumers' interests by removing the BOCs' incentives to open their markets to competition.

102. There is no evidence that additional regulation of long-distance providers is warranted. There is, moreover, significant evidence that such regulation would be harmful to the interests of consumers. The Commission should not retreat from its successful deregulation of the competitive long-distance industry, but should instead focus on promoting competition in local exchange markets.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief. Executed on September 20, 1999.



Gregory L. Rosston